Facts About Education Zone Academy Bonds For Elementary and Secondary Education

Instructions for Preparing a Qualified Zone Academy Bond Application

Section 226 of the Taxpayer Relief Act of 1997 (Public Law 105-34) provides a source of capital at no or nominal interest rates for costs incurred by certain public schools in connection with the establishment of special academic programs from kindergarten through secondary school, in partnership with the business community.

On January 7, 1998, the Internal Revenue Service published temporary regulations to implement the qualified zone academy bond provisions. On that date, the Internal Revenue Service also published the allocation for calendar year 1998 of the nation $400 million cap among the States. The regulations and allocation were published in the Federal Register on January 7, 1998.

The following is a description of the newly enacted provisions and implementing regulations written as questions frequently asked and the appropriate answers, with insertions specific to such programs in Tennessee.

Contact Information

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1. **What is the new source of capital?**

1. In summary, the program permits local governments to borrow money from financial institutions at no or nominal interest rates by issuing qualified zone academy bonds (QZABs). As described below, interest on those bonds will in effect be paid by the Federal government through a tax credit to the holder. The term of the bond issue will be limited based on a formula.

2.

What schools can take advantage of this new source of capital?

The program is available to public schools located in empowerment zones or enterprise communities (including zones and communities designated in the future) and public schools located in other areas where there is a reasonable expectation that at least 35 percent of the students (or participants in the program) will be eligible for free or reduced-cost lunches under the Federal school lunch program.

The eligibility criteria are applied on a school-by-school basis not a system-wide basis. For example, if a specific school meets the 35 percent requirement described above, that school is eligible even if it is part of a system that does not meet that requirement overall. Under the National School Lunch Act, free meals are provided for students from families whose income is below 130 percent of the Federal poverty level; subsidized meals are provided if the family's income is between 130 percent and 180 percent of the Federal poverty level.

To apply for local government authority to issue QZABs in Tennessee, a school, in conjunction with its local Board of Education and local government unit, must complete the attached application and submit it according to the instructions.

3.

What actions must a school undertake to participate?

The school must enter into a public-private partnership. This means that the academic program of the school must be designed in cooperation with business to enhance the academic curriculum, increase graduation and employment rates, and better prepare students for the rigors of college and the increasingly complex workforce and that the school must have commitments of substantial business support. The program does not exempt the school from requirements applicable to other schools in the system. Therefore, students in the school must be subject to the same academic standards and assessments as other students educated by the local school system, and the comprehensive education plan of the public school must be approved by the local school system.

In Tennessee, the school may apply through the local Education Edge partnership or, if no partnership exists, may develop a partnership that consists of parents, students, educators, community members, organized labor (if applicable), with at least 50% business representation.

4.

How does a school meet the requirement of substantial business support?

The local school board that establishes the school or program must have written commitments from private entities that the private entities will make "qualified contributions" to the school in an amount not less than 10 percent of the capital provided under section 226 of the Act.

Qualified contributions are contributions (of a type and quality acceptable to the local school board) of:

- equipment for use in the school (or program) including state-of-the-art technology and vocational equipment;
- technical assistance in developing curriculum or in training teachers in order to promote appropriate market-driven technology in the classroom;
- services of employees as volunteer mentors;
- internships, field trips, or other educational opportunities outside the academy for students; or
- any other property or service specified by the local school board.

In general, it is intended that the value of qualified contributions will be determined in the manner used to determine the value of charitable contributions under current law. Under current law, if an employer contributes services of an employee, wages paid to the employee and allocable to those services may be deductible under section 162, not section 170. It is intended that wages allocable to donated services performed by employees will be taken into account in determining the amount of qualified contributions. If the contribution is to be made in the future, it will be discounted to its present value as of the time the interest-free capital is provided.

5.

What are the qualifications and conditions associated with this new capital source?

Specifically, the local government can issue a "qualified zone academy bond". To qualify,

- 95 percent or more of the proceeds of the issue must be used for a qualified purpose with

respect to a school described above in questions 2 and 3.
- The bond must be issued by a State or local government within the jurisdiction of which the school is located.
- The issuer must designate the bond for purposes of this provision.
- The issuer must certify that it has written assurances that the private business contribution requirement (described under question 3) will be met with respect to the school, and must certify that it has the written approval of the local school board for the issuance.
- The term of each bond in the issue cannot be longer than the Secretary of the Treasury estimates will result in the present value of the obligation to repay the principal on the bond being equal to 50 percent of the face amount of the bond (rounded up to a whole year).

The local government does not have to have a formal bond issue to participate in the program. A simple loan from a local financial institution can qualify as long as it meets the requirements described above.

The discussion above sets forth the Federal requirements. Obviously, qualified zone academy bonds must be issued in accordance with State or local borrowing requirements.

§49-3-1206(d)(2), TCA states "Counties having a city or cities operating schools independent of the county or having special school districts operating schools independent of the county shall not be required to share proceeds of any loan agreement of a qualified zone academy project, notwithstanding any other law to the contrary".

6.

What are the qualified purposes for which this interest free capital may be used?

In Tennessee, the qualified purposes are the following:

- Rehabilitating, renovating, or repairing a facility for use by public schools
- Providing equipment for use at the qualifying school.

7.

How will the Internal Revenue Service administer the eligibility requirements?

The Temporary Regulations do not provide guidance beyond that contained in the statute on the specific eligibility requirements discussed above. However, the regulations provide that the determination of whether the school meets those eligibility requirements will be made by the issuer and those determinations will not be challenged by the IRS and may be relied on by the purchasers of the qualified bonds if there was a reasonable basis for the determinations.

Quite simply, the issuer determines whether the bond is eligible and that determination is binding on the IRS unless it does not have a reasonable basis. With one exception discussed below, changes in circumstances after the bond is issued will not affect the qualified status of the bond.

The law requires that 95 percent of the proceeds from the borrowing must be used for a qualified purpose. The regulations provide that the definition of qualified purposes contained in the statute is to be broadly interpreted. If changes in circumstances result in the issuer not being able to actually spend 95 percent of the bond proceeds for a qualified purpose, the issuer must utilize remedial actions (such as redeeming a portion of the issue) to preserve the qualification of the bond. These remedial actions are similar to those provided in tax-exempt bond regulations.

8.
Who can purchase these bonds, and how is the interest subsidy provided?

The local government's bond issue can be purchased by banks (within the meaning of Internal Revenue Code section 581), insurance companies (to which subchapter L of the Internal Revenue Code applies), and corporations actively engaged in the business of lending money. The program was limited to these institutions for administrative reasons and to prevent competition with issuance of regular tax-exempt bonds.

Rather than being paid interest by the bond issuer, purchasers of qualified zone academy bonds will receive an annual Federal income tax credit equal to the principal amount of the bond times 110 percent of the applicable Federal long-term rate (AFR) for the month in which the bond was issued.

Under current law, the Treasury Department publishes the long-term AFT on a monthly basis. That rate is the current market yield on Federal obligations with remaining terms to maturity over 9 years. The rate for any month is determined in advance based on the market yields in effect in the preceding month.

The Treasury Department has determined that using 110 percent of the long-term AFR will minimize premium and discount on qualified zone bonds. It was not possible for the Treasury to prescribe a single credit rate that would permit all qualified zone academy bonds to be issued at par without interest cost. Borrowers have different credit ratings and market yields may change after determination of the long-term AFR. The issuer may issue the bond at premium or discount or provide for additional interest payments to take into account those factors.

For example, if an issuer had issued a qualified zone academy bond in January of 1998, the holder of that bond would have received an annual credit equal to 6.75 percent of the principal amount of the bond and the maximum term of that bond would have been 13 years. Since interest rates dropped after the point when the Department of the Treasury determined the long-term AFR for January of 1998, it is quite possible that qualified zone academy bonds would have been issued during January of 1998 at a premium.

What is the tax treatment of the purchaser of qualified zone academy bonds?

The purchaser of a qualified zone academy bond is eligible for an annual tax credit in an amount described above. That credit effectively makes the bond purchaser whole as though it purchased a taxable bond. The tax credit allowed to the purchaser cannot exceed the purchaser's net federal income tax liability. The temporary regulations treat that credit as if it were taxable interest for all purposes of the tax law. In addition, any premium or discount on the bond will be treated as premium or discount on a taxable obligation.

10.
What can a holder do if it has insufficient Federal tax liability to fully utilize the credit?

Qualified zone academy bonds are freely transferable and therefore, taxpayers who do not have sufficient federal income tax liability to fully utilize the credit may transfer the bond to other taxpayers who can fully utilize the credit. The credit is allowed to the taxpayer who holds the bond on the credit allowance date regardless of how recently the taxpayer acquired the bond. This is similar to taxable bonds with interest payments where the interest payment is made to the holder on the interest payment date. There are no restrictions such as those applicable to the dividends received deduction on how the transfer could be made. For example, a taxpayer with insufficient tax liability to utilize the full credit could transfer the bond to another taxpayer pursuant to a repurchase agreement. As long as the other taxpayer holds the bond on the credit allowance date, it will receive the credit even if it is required to return the bond to the original taxpayer pursuant to the repurchase agreement.

11.
Are there limits on the amount of bonds that can be issued under the program?

Applications will be accepted twice annually, March 1 and September 1, until all funds have been obligated and/or the Federal government ceases the program. Applications must be submitted to the State Department of Education with a postmark on or before the deadline dates of March 1 or September 1. When the Department of Education receives at least $5,000,000 in requests, a recommendation will be made to the Tennessee State School Bond Authority for the issuance of QZABs. Bond proceeds will be available approximately ninety (90) days after the application deadline, June 1 and December 1, provided applications received from all schools and recommended by the Department of Education exceed $5,000,000 in total. Successful applicants will be notified in writing.

EXAMPLE OF HOW A QZAB COULD WORK

A for-profit hospital is a major employer in the community. It has indicated a willingness to cooperate with a local school to establish a special academic program that would prepare students for jobs at its institution. The hospital has agreed to donate state-of-the-art medical equipment and computer software to the school, to facilitate training for teachers on using the equipment, to provide teaching materials, and to provide internship and mentoring experiences for students. The school has determined that it needs to renovate a classroom to prepare a laboratory to accommodate the donated equipment and purchase additional computers to run the software along with some furnishings. The school estimates that this would cost $500,000.

In order to obtain the benefits of the low-cost capital afforded through the Qualified Zone Academy Bond ("QZAB") tax credit, the school would need to take the following steps:

1. The school obtains from the hospital an estimate of the value of the equipment, software, teacher training, and personnel time and facility cost associated with the internship and mentorship opportunities. Regular tax rules concerning the donation of equipment, personnel time and associated costs of administering the internship and mentorship program would apply.
2. If the value of the hospital's donation is equal to at least 10 percent of the gross bond proceeds (10% of $500,000 or $50,000 in the example provided), the school would obtain a written commitment from the hospital of this donation.
3. The school contacts the financial officer and other school system personnel responsible for debt issuance. The QZAB must be issued by a state or local governmental unit. In most cases, the likely issuer would be the local education authority, but the local or state government may issue the QZABs in other cases.
4. The parties may determine the source of repayment of the $500,000. The QZAB tax credit mechanism may eliminate the interest cost, but the QZAB is still a loan that must be repaid.
5. The school system seeks an allocation from the State Department of Education for an amount equal to $500,000 (the amount the school expects to borrow). The State Department of Education must then provide a written verification of an allocation of the QZAB volume limitation.
6. Arrangements are made by the school bond authority with a financial institution, bank, insurance company, or corporation in the business of lending money to purchase the QZAB. The local government enters into a loan agreement with the Tennessee School Bond Authority.
7. The proceeds of the QZABs are used to renovate the classroom and purchase equipment